HERBERT SMITH FREEHILLS

FSR OUTLOOK 2022: REGULATORY SCRUTINY OF DEBT CAPITAL MARKETS SET TO INCREASE

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Legal Briefings

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The scrutiny of conduct in capital markets, particularly in handling conflicts of interest, will ramp up in 2022.

In a nutshell:
- **As debt markets become less opaque, with the availability of more data and advanced analytics, regulatory scrutiny of how they operate is growing**
- **Across a range of jurisdictions, regulators are probing how firms manage potential conflicts of interest in the debt capital raising process, and whether confidential or inside information is properly controlled**
- **Firms should expect to see more scrutiny and enforcement action in this area in the coming year**

Regulatory scrutiny of debt capital markets will increase

Regulatory interest in the previously opaque debt capital markets has been intensifying, albeit very gradually. The LIBOR rate fixing scandal, as it unfolded from 2007 to 2013, was an early prompt, and the UK FCA took some early enforcement actions for market misconduct in debt markets from 2007 onwards. But the global pace is picking up. In 2018, the Markets in Financial Instruments Directive and Regulation (MiFID II) introduced enhanced rules governing the provision of underwriting and placing services, including specific requirements for managing conflicts of interest and the allocations process, and pre-and post-trade transparency requirements which have given regulators much greater oversight of the operation of the debt markets in the European Union. And the recommendations in the International Organisation of Securities Commissions (IOSCO)'s 2020 Final Report on *Conflicts of interest and associated conduct risks during the debt capital raising process* are now prompting action.

With this background in mind, we anticipate that scrutiny of the debt capital markets will be a key focus for regulators next year, with some slight variations in focus and approach across different jurisdictions.

In the wake of the **UK's** exit from the EU, the FCA and HM Treasury have been consulting on proposed reform of the UK regulatory landscape with the aim of ensuring that UK regulation remains fit for purpose and can support future growth. These reforms are likely to take shape in 2022. The UK Government considers that the MiFID II regime delivered little meaningful transparency, and had limited impact on price formation, but at a high cost to industry. So proposed Government reforms would recalibrate (but not remove) the transparency regime for fixed income and derivatives markets, with a shift from regular liquidity calculations based on quantitative criteria only, to qualitative and quantitative criteria. In relation to benchmarks reform, the UK Financial Services Act 2021 gives the FCA new and enhanced powers to manage the wind-down of critical benchmarks such as LIBOR. The exercise of these powers will be crucial in tackling the remaining stock of tough legacy contracts, particularly in the bond markets.

However, market conduct in debt capital markets, particularly around the management of conflicts of interest, and the control of inside information, remain key FCA priorities, following some significant early mover supervisory and competition work on conflicts, allocation processes and the role of analysts in both equity and debt markets undertaken in 2013 - 2015. Access to transaction reports and order books, combined with increased processing capability and use of advanced analytics, now provide the FCA with an almost real time algorithmic radar across trading. Regardless of post-Brexit fine-tuning of MiFID II, we expect to see more enforcement activity in debt markets in the UK in the coming year. In particular, the IOSCO Final Report refers to a small number of banks having acted opportunistically during the pandemic and using their lending relationship to exert pressure on their corporate clients to secure roles on future primary market mandates.

In **Australia**, we predict that debt transactions will be a key focus for the Australian Securities and Investments Commission (ASIC) in 2022. In September 2020, ASIC had signalled that debt transactions were on its radar: ASIC Report 668 focuses on allocations in debt capital raisings and select transactions from 2018-20. It revealed concerns in relation to, among other things, the handling of conflicts of interest and inside information, and an unduly “light touch” approach within firms to the supervision and monitoring of debt transactions. ASIC launched a high profile insider trading case against a bank for its involvement in the largest interest rate swap executed in a single tranche in Australian financial market history. The case, which will be heard in 2022 or 2023, is a clear sign of ASIC's willingness to review previous debt transactions and to commence court proceedings. The outcome will be closely watched by market participants and their advisers.

In **Hong Kong**, the Securities and Futures Commission (SFC) has recently finalised new code requirements for intermediaries carrying out bookbuilding, pricing and placing activities in debt and equity capital market transactions. These new requirements will come into effect on 5 August 2022 and cover a spectrum of activities, including assessing the issuer and the offering, advising the issuer, marketing, bookbuilding, pricing, allocation and placing, and record keeping. They were formulated with reference to the 2020 IOSCO report discussed above, as well as the outcome of the SFC's thematic review following the publication of that report – tackling issues such as lack of transparency in orders placed, conflicts of interest where syndicate members invest on behalf of clients and on a proprietary basis, and preferential treatment or rebates paid to investors.

Separately, we expect The Stock Exchange of Hong Kong Limited to closely monitor the market for compliance with the enhanced professional debt regime requirements, which it implemented on 1 November 2020.

In **the US**, we expect transparency and competition in the bond markets to be a key focus for the US Securities and Exchange Commission (SEC). The SEC has already indicated to market participants that it is considering appropriate reforms with respect to post-trade transparency and the trading platforms for corporate bonds, mortgage markets, asset-backed securities, and municipal bonds. In particular, the SEC has indicated that it is concerned with the accessibility of pre-trade price information made available to professional investors in the corporate bond market. We expect that the SEC will be closely monitoring the accessibility of pre-trade price information available to professional investors. We also expect that regulations in the coming year will follow, focusing on broadening the dissemination of pre-trade information in order to make the corporate bond market more accessible, competitive and liquid.

In all the jurisdictions covered in this article, there is evidence of regulatory concern about the way firms handle the conflicts that may arise from the proprietary interest an intermediary firm may have in a transaction, and the multiple roles and range of services intermediaries provide to their clients. The regulatory expectation that market participants should continue to provide fair treatment to corporate clients during periods of disruption is very clear.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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